LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
MAY 1 1965
JOHN F. DAVIS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1964

No. [redacted] 101

RITA G. SHEPHARD, Guardian of
Susan Shephard, - - - - - - Petitioner,

versus

UNITED STATES OF AMERICA, - - Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

WILLIAM R. BAGBY,
1107 First National Building,
Lexington, Kentucky,
Counsel for Petitioner.

WESTERFIELD-BONTE CO., INCORPORATED, LOUISVILLE, KY.

INDEX.

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2–3
Statutes Involved	4
Statement	4–13
Reason for Granting the Writ	13–19
Conclusion	19
Appendix A	21–26
Appendix B	26–27

CITATIONS.

Cases:

	PAGE
Baltimore Dairy Lunch, Inc. v. U. S., 231 F. 2d 870	18
Bonwit v. Commissioner (2d Cir.), 87 F. 2d 764	14
Burnet v. Wells, 289 U. S. 670 (1933)	14
Comm. v. Court Holding Co., 324 U. S. 331	15
Comm. v. Heininger (1943), 320 U. S. 467	19
Christopher v. Burnett (1931), 55 F. 2d 527 (Ct. of App., Dist. of Col.)	16
Electric Machine Co. v. Comm. (1957), 242 F. 2d 947	19
Helvering v. Midland Mutual Life Insurance Co., 300 U. S. 216, 223	15
Helvering v. Tex-Penn Oil Co. (1937), 300 U. S. 481	19
Regensburg v. Commissioner (1943), 144 F. 2d 41 (2d Cir.)	16–17
Wall v. United States (1947), 164 F. 2d 462	15
Whitfield v. Commissioner (1962), 311 F. 2d 640	17–18
U. S. v. United States Gypsum Co. (1948), 333 U. S. 364, 395	18
Yuengling v. Commissioner (3d Cir.), 69 F. 2d 971	14

Statutes:

Internal Revenue Code of 1954:	
Sec. 301 (26 U.S.C. 1958 ed., Sec. 301)	26
Sec. 316 (26 U.S.C. 1958 ed., Sec. 316)	27
Regulations:	
Section 1.301-1	27

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1964

No. _____.

RITA G. SHEPHARD, Guardian of
Susan Shephard, - - - - - *Petitioner,*

v.

UNITED STATES OF AMERICA, - - *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

The petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in this case.

OPINIONS BELOW.

The opinion of the Court of Appeals (Appendix A, *infra,* pp. 21-25) is reported at 340 F. 2d 27 (1964). The opinion of the Tax Court (R. 26a-41a) is not reported.

JURISDICTION.

The judgment of the Court of Appeals was entered on January 14, 1965 (Appendix A, *infra*, p. 26). The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED.

On January 31, 1944, a small laundry corporation and its sole stockholder became jointly liable on 84 monthly notes covering seven years. The notes were given as the major payment for the purchase by the stockholder of all the outstanding stock in the corporation, which stock was issued in his name. The corporation paid the first 69 notes which became due and they were charged to an account in its books as "Accounts Receivable—Clarence E. Shephard." During the 13½-year period from January 31, 1944 to the stockholder's death on July 25, 1957, eight other debits were entered to this account plus only two nominal payments.

During the casual administration of the stockholder's estate by a bank the independent accountant for the corporation wrote off the balance of $24,241.32 showing to be due in the account. The accountant acted arbitrarily, without advice or instruction from anyone. The accountant wrote it off because he believed it to be a bad debt prior to Shephard's death, as he had been accountant for Mr. Shephard and the corporation for several years. There was no evidence in the record of the case revealing that the corporation,

or its interim, temporary and practically unknown operators ever knew anything at all about the entry. The administrator of the estate in a very short oral exchange with the accountant asked, "What account?" and stated that the account would not be paid, and the accountant interpreted this to mean that the estate was without funds to pay the account. The administrator did not know about the account until seven months after the stockholder's death.

The main asset in the estate of the deceased was the stock in the corporation. The net value of the estate was the same after the write-off by the accountant as before.

1. Whether the contract made by the corporation to pay the joint notes resulted in dividends to the stockholder in each year the note payments were made by the corporation?

2. Whether the account in the name of the stockholder was in form an account receivable but in substance a surplus account?

3. Whether it is necessary to have an economic benefit to a stockholder before there can be a taxable dividend and whether there was an economic benefit to the infant guardian or the estate by the arbitrary write-off by the accountant?

4. Whether the write-off by the independent accountant was a corporate act or was his own?

STATUTES INVOLVED.

The pertinent provisions of Sections 301 and 316 of the Internal Revenue Code of 1954 are set forth in Appendix B, *infra,* pp. 26-27).

STATEMENT.

Clarence E. Shephard, of Lexington, Kentucky, died intestate July 25, 1957 and the next day a Kentucky bank was appointed administrator, with the duties performed by a trust officer (R. 13a, 15a). Susan Shephard, the deceased's infant daughter (under 14 years of age), who resided in Columbus, Ohio, with her petitioner-guardian mother was his sole heir (R. 12a, Appendix, p. 5).

The primary asset in the Shephard personal estate consisted of 224 of the 250 outstanding shares of stock in a small laundry corporation in Lexington, Kentucky, which shares were distributed by the administrator to the guardian on April 21, 1958 (R. 13a, 14a).

Shephard acquired the 224 shares through a contract made January 31, 1944, by which he agreed to purchase the 250 outstanding shares of the laundry corporation at a price of $29,000 with $8,000 down and the $21,000 balance payable with 84 notes, each for $250 plus interest of $46.80, with a note due each month over a seven-year period (R. 12a). The contract between him and the seller also required the corporation, after formal authorization, to co-sign the 84 notes and to pledge its assets (R. 12a). Accord-

ingly, the stockholders and directors voted to borrow the money from the seller, to execute the 84 promissory notes and a chattel mortgage as security, and to make the money available to Shephard to pay the $21,000 to the seller (R. 12a; Appendix 13a, 14a, 15a, 16a).

Accordingly, the $8,000 was personally paid by Shephard and the 84 notes, for the purchase price balance of $21,000, were executed to the seller jointly by the corporation and Shephard (R. 12a). As security, a mortgage was executed by the corporation. The 250 shares of the stock in the corporation were then transferred by the seller to Shephard (R. 12a, 15a). Sometime later Shephard sold 25 shares to a sister-in-law and one was held by a nominee (R. 15a).

The corporation, by its execution of the notes, therefore contracted to make available from its earnings and/or surplus the money necessary to make the payment of each note (R. 12a; Appendix 13a, 14a, 15a, 16a). If earnings or surplus proved insufficient, the assets of the corporation were pledged as a secondary source.

Only the last 15 of the 84 payments of the joint notes were made by Shephard himself (R. 13a). The corporation, however, made the first 69 consecutive monthly note payments with 64 corporate checks issued directly to the seller over a period spanning nearly six years, from March 28, 1944 through December 3, 1950 (R. 13a). Fifty-nine checks issued to the seller were each for $296.80 ($250 note plus $46.80 interest) and five were each for $593.60 ($500 note plus $93.60 interest) (R. 13a, 45a, 46a, 47a).

The 69 notes paid plus interest, upon being paid, were not entered and reflected in a "Note Receivable—Clarence E. Shephard" account in the books of the corporation. In fact, there was no such account in the books and records of the corporation (Entire Record). Instead, the 64 checks, totalling $20,429.20, were each entered on the company books in an account receivable in Mr. Shephard's name (R. 13a). The 69 notes paid by the corporation (plus interest) were not reflected as "Notes Receivable, Clarence E. Shephard" as an asset in the books and records of the corporation but these notes disappeared, vanished or were cancelled (Entire Record).

There were eight charges, other than the 69 note payments, to the Shephard account totalling $6,812.12 during the period November, 1948 to March, 1957, making a grand total of $27,291.32 of all charges to this account (R. 13a).

No interest was ever paid to the corporation by Shephard and no interest was ever charged to his so-called receivable account because of the 69 notes plus interest which were paid by the corporation; and, no interest was ever paid by Shephard or charged to his so-called receivable account because of the other 8 items which had been charged to the account (Entire Record).

During the long period of 13 years from his purchase of the stock on January 31, 1944, to his death on July 25, 1957, the only credits to this account was

one on May 20, 1944, for $200 and another on April 24, 1948, for $2,850.00[1] (R. 13a).

The books and records of the laundry corporation for many years were located with and kept by an independent accountant in his own offices (R. 19a). A great many of the entries involving the note payments were made by him (R. 19a, 20a, 21a).

The debit balance in the Shephard account, in the corporate books, at his death on July 25, 1957 was $24,241.27 (R. 13a). It was however seven full months, after the death of Shephard, before the trust officer, as administrator, learned that such an account even existed (R. 24a, 25a).

Shortly before the close of the corporation fiscal tax year ended February 28, 1958, the accountant wondered what he was to do with the Shephard account. He very briefly, therefore, discussed the matter with the trust officer who expressed shock at the existence of such an account by exclaiming, "What account?" (R. 25a). Thereupon the trust officer advised the accountant that such an account would never be paid (R. 25a). The full text of this very brief oral exchange, as related by the accountant, is as follows (R. 25a):

> "I asked Mr. Slaton something about this account, and he said *'What account?'* I explained it to him and he said, *'It will never be paid. I don't care what you do with it.'*" (Emphasis supplied.)

[1]The 25 shares acquired by his sister-in-law presumably cost her about the same rate as Shephard or $116 per share or $2,900 which could have been credited to the Shephard account.

The accountant interpreted the trust officer, by his statement above, to mean that the estate was not financially able to pay the account. As the result of this conversation, the accountant determined that the account was fictitious, misleading and that it had become a bad debt at sometime prior to February 28, 1957, which was prior to the death of Shephard (R. 25a, 26a). The accountant, having been acquainted with Mr. Shephard during his lifetime, realized that he had never intended to pay the account and he knew that Shephard had died without ever having done so. On February 22, 1958, the accountant therefore, without the advice by the corporation or the instruction from any one in the corporation, but arbitrarily on his own, made a closing entry for the fiscal year 1958, writing off the account by charging surplus and crediting the Shephard account with the balance of $24,241.22 (R. 20a, 21a).

The minutes of the meetings of the Board of Directors and the stockholders are completely void with respect to the write-off entry by the accountant and with respect to any cancellation of debt (R. 16a). The write-off was solely therefore the indivdual and personal product of the accountant and not the product or act of the corporation.

Neither the accountant nor the trust officer was an officer or director of the laundry corporation. The record in this case is void of any evidence as to the identity of the president of the corporation while it was being administered by the bank as a part of the estate. The only officer revealed by the record was

one Norman B. Fildes, who appears as a "General Manager and Vice-President" in the corporate income tax return filed in April, 1958 for the fiscal year ended February 28, 1957 (Exhibit A).

The record is a void as to the knowledge by any officer, director or stockholder of the corporation as to the entry of the so-called write-off by the accountant (Entire Record). The only one who had actual knowledge of the entry was the independent accountant, who made the entry in the books in his office and not at the laundry place.

The accountant prepared financial statements showing the condition of the corporate finances every four weeks and these statements were sent only to the laundry establishment but never to the bank or to the trust officer (R. 34a). The only person at the laundry was the hired manager and not the bank (R. 34a).

After he had made the write-off entry on February 22, 1958 and prior to the time the laundry corporation stock was transferred to the guardian on April 21, 1958, the accountant had sent to the laundry place a statement for only the two months ended February 28 and March 31, 1958 (R. 20a, 49a).

There is no evidence in the record to show that anyone, not even the laundry manager, ever saw, looked at or even received the financial statements prepared by the accountant (Entire Record). There is no evidence of any kind indicating knowledge by any officer or director or stockholder of the corporation of the contents of the financial statements (Entire Record).

The corporate income tax return for the fiscal year ended February 28, 1958, prepared by the accountant, reported an earned surplus which had been reduced by the Shephard account balance of $24,241.32, with the explanation that the account was a "non-deductible bad debt." The $24,241.32 was not taken as a bad debt deduction in the corporate return for the year ended February 28, 1958 (R. 15a). By this the accountant determined the account a bad debt prior to the death of Shephard.

The Shephard account balance of $24,241.32 was not paid by his estate (R. 15a, 51a to 54a, inclusive).

The Shephard account balance of $24,241.32 was included in determining the value of the 224 shares for the estate inventory and appraisal filed September 30, 1957 (R. 14a). However, the Shephard account was excluded in determining the value of the stock for the Federal Estate Return filed July 19, 1958 (R. 15a). Figures for both were supplied by the accountant (R. 14a, 15a).

This case arose from the determination by the Commissioner of Internal Revenue that the personal write-off by the independent accountant of the Shephard account balance of $24,241.27, was a corporate act of cancellation of a debt (under Sections 301 and 316(a) of the Internal Revenue Code) which created a dividend to the estate-stockholder (R. 3a, 4a). The resulting additional income tax of $8,687.50, plus six per cent interest from April 15, 1959, for the calendar year 1958 was assessed against the guardian

of the infant Susan Shephard, as a transferee from the estate (R. 3a, 5a).

The Tax Court (R. 41a) and the Circuit Court for the Sixth Circuit sustained the Commissioner (340 F. 2d 27).

The decision of the Circuit Court was based upon conclusions that the arbitrary act by the independent accountant was a corporate act of canceling or charging off the Shephard account.

The petitioner had argued before the Circuit Court that the note payments by the corporation were dividends in the year made, as well as the eight other duties (Appendix A, *infra*, p. 24).

The Court of Appeals for the Sixth Circuit held that both the corporation and Mr. Shephard, prior to his death, had treated "the transaction" as an indebtedness and not as a distribution of earnings. This latter conclusion was based upon the following three factors:

> (1) That the corporation carried the account on its books and records as a receivable and carried the debit balance of the account as an asset on its balance sheets.
>
> (2) That Mr. Shephard recognized the debt by making two payments on the account.
>
> (3) That the petitioner made no showing before the Tax Court that Mr. Shephard had treated the 64 note payments and the eight withdrawals as income in any returns during his lifetime.

The value of the 224 shares of stock reported in the Federal Estate return was $29,950.37 which value did not include (as an asset) the $24,241.32 Shephard account. The purchase price of the stock in 1944 was $29,000. The formal resolutions, passed by both the stockholders and directors of the corporation, established a plan for dividends to be declared monthly from current profits or surplus of the corporation to be used in paying off the notes due monthly (R. 13a; Appendix 7a-17a).

The only testimony by a witness by stipulation or by actual presence in the courtroom, was given by the accountant as a witness in the trial of the case in the Tax Court (R. 12a-27a). He testified that he considered and determined the Shephard account to have been bad prior to Shephard's death. He had been accountant for the laundry and associated with Shephard for several years and it was his determination that the Shephard account was in form a receivable but in substance a bad debt, prior to Shephard's death.

Susan Shephard, the infant heir, and her guardian had no part whatsoever in the closing entry which eliminated the $24,241.32 as a bad debt on the company books. They knew nothing at all about the entry when it was made or afterwards, until this case arose (Entire Record).

Since the stock she inherited was not increased a cent in value by the accountant's write-off of the bad debt, neither the infant heir, Susan Shephard, nor the deceased's estate received any benefit from the com-

pany in 1958 which was or could be determined to be a dividend. No dividends were declared by the company (Entire Record).[2]

REASONS FOR GRANTING THE WRIT.

(1) The decision below is in direct conflict with this Court in *Burnet* v. *Wells,* 289 U. S. 670 (1933). In the latter case, the income from trusts, created by a taxpayer, was to be used and was used to pay premiums on insurance policies on his life and with his family the beneficiary. This Court held that the trust income must be reported by the taxpayer in his return because a life insurance policy is a contract susceptible of ownership, and this, whether or not the trust was revocable or irrevocable. This Court there stated, as follows:

---

[2]The lack of benefit to the infant heir may be more clearly revealed as follows—Assume that all "Other Assets of the Estate" except the stock worth $29,950.33 were worth $24,241.32 and assume that the estate did owe the company $24,241.32 and that the administrator used the "Other Assets" to pay off the account to the company, then, *after* the payment, the following would be the picture:

Stock as Asset is Worth	plus	Other Assets are Worth	equals	Net Assets are Worth
$54,191.69		-0-		$54,191.69

However, in the instant case, the fictitious account of $24,241.32 was written off and the "Other Assets" remained intact and the following is the picture:

Stock as Asset is Worth	plus	Other Assets are Worth	equals	Net Assets are Worth
$29,950.37		$24,241.32		$54,191.69

A comparison of the above schedule shows that both arrive at the same "Net Assets Worth" of $54,191.69, revealing that the infant heir as the real stockholder in this case received no benefit from the accountant's write-off entry of the fictitious account.

> "A policy of life insurance is a contract susceptible of ownership like any other chose in action . . ."

The lower court decision is also in direct conflict with decisions by the Court of Appeals for the Second, Third and Fourth Circuits.

The decision of the Court for the Third Circuit in the case of *Yuengling* v. *Commissioner* (1934), 69 F. 2d 971, was that life insurance premiums paid by a corporation on the life of its sole stockholder were dividends to him where the corporation was not a beneficiary but where the beneficiary under the policies was a trustee for the stockholder, who held the policies for the benefit of the stockholder's wife and children. The court there reasoned that the corporation *did not benefit* from the policies but that the stockholder *did benefit* from the payment of the premiums. The Court there stated as follows:

> "The facts are substantially the same as those considered by the Supreme Court when it decided this question in *Burnet* v. *Wells,* 289 U. S. 670. Accordingly, upon the authority of that case, we hold that such income is taxable to the petitioner."

The decision of the Court for the Second Circuit in the case of *Commissioner* v. *Paul J. Bonwit* (1937), 87 F. 2d 764, was that insurance premiums paid by a corporation on the life of its major stockholder-president were additional compensation to him in the year made. The corporation applied for the insurance on the stockholder's life, paid the premiums, and

named itself as beneficiary. Later, the corporation was replaced as beneficiary by the stockholder's wife and sons. The court there said:

> ". . . *A corporation may not lawfully give away its property in order to gratify an individual;* hence there is a presumption that payments beneficial to an employee *are intended as additional compensation* rather than gifts. *Noel* v. *Parrott,* 15 F. 2d 669, 671 (C.C.A. 4), cert. denied 273 U. S. 754; *Fisher* v. *Commissioner,* 59 F. 2d 192, 193 (C.C.A. 2); *Yuengling* v. *Commissioner,* 69 F. 2d 971, 972 (C.C.A. 3)." (Emphasis supplied.)

The decision of the lower court is in conflict with the Court of Appeals for the Fourth Circuit in the case of *Wall* v. *United States* (1947), 164 F. 2d 462, where the Court stated:

> ". . . and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt."

(2) The decision below is in direct conflict with this Court in *Helvering* v. *Midland Mutual Life Insurance Company,* 300 U. S. 216, 223, where this Court held the incidence of taxation depends upon the substance rather than the form of the transaction. Also, *Commissioner* v. *Court Holding Co.,* 324 U. S. 331. That is to say, the treatment of accounts on the corporate records is not controlling when such treatment

is contrary to the realities of the transaction. An account may be in form an account receivable but in substance or reality it is a surplus or dividend account.

The decision below is also in direct conflict with the Court of Appeals for the District of Columbia in the case of *Christopher* v. *Burnet* (1931), 55 F. 2d 527, 528, wherein that Court stated:

> "It is settled law that *no formal dividend declaration is necessary where substantially all the stock is owned by a single individual.*" (Emphasis supplied.)

The court there also stated as follows:

> ". . . *mere* entries made on the books . . . can not convert into an asset what was in fact a distribution." (Emphasis supplied.)

The decision below is in direct conflict with the Court of Appeals for the Second Circuit in the case of *Regensburg* v. *Commissioner* (1943), 144 F. 2d 41. That court held that withdrawals, under circumstances similar to those in the instant case, were in the years received. The court there stated it as follows:

> "That the withdrawals were recorded on the corporate books as debits against the taxpayers; that they were not proportionate to holdings of stock nor participated in by all the shareholders; and that the formalities of a dividend declaration were lacking is not conclusive against a finding that the withdrawals were dividends . . .
>
> . . . . . .

> "If the sums withdrawn were actually intended to be loans, *it seems extraordinary that they should have been allowed to roll up for nearly forty years* until they reached the staggering total of more than $3,000,000 owing by persons who had nothing but their shares of stock with which to pay." (Emphasis supplied.)

(3) The decision of the lower court is in direct conflict with the Court of Appeals for the Fifth Circuit in the case of *Whitfield* v. *Commissioner* (1962), 311 F. 2d 640. In a strikingly similar fact situation as the instant case, the Fifth Circuit Court in the *Whitfield* case, *supra,* in holding that no dividend resulted to an estate in the absence of an economic benefit, stated as follows:

> "It is not enough to say, as the Commissioner does, that the 'grantor (father), and after his death his estate, were enriched to the extent of the amount of the debt, which he had taken out of the corporation and had never repaid.' This is putting the cart before the horse. *There was a constructive cancellation amounting to a dividend only if there were some legally recognized benefits to the estate in that year,* and that is the question before us. It may be well that, if there were such a constructive dividend to the estate in 1956, taxpayer received taxable income in that year as to his share of that enrichment. But the enrichment must arise from a cancellation of the debt, not a receipt of the money by the father prior to his death fourteen years before. For, if the latter were the test, the tax was due when the debt was incurred—and that is certainly not the position taken by the Commissioner.

"An analysis of the undisputed facts shows that nothing happened in 1956 which put the estate, and thus the taxpayer, in any better position than it had been in 1955 or any other time prior to the alleged 'constructive cancellations.'

. . . .

"It is plain therefore, that there was nothing in the record before the Tax Court to support the conclusion that there had been a cancellation of the debt of the estate to Alaga, constructive or otherwise. *And, if there had been such proof, such a cancellation would not supply the basis for taxation as a dividend because the proof further established without dispute that there had been no benefit or enrichment either of the estate or the taxpayer.*" (Emphasis supplied.)

(4) The findings of the Tax Court are "clearly erroneous" and are therefore in conflict with this Court in *U. S.* v. *United States Gypsum Co.* (1948), 333 U. S. 364, 395, where this Court said that a finding is "clearly erroneous" when, "although there is evidence to support, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."

The decision in the instant case appears in conflict with the Court of Appeals for the Eighth Circuit in *Baltimore Dairy Lunch, Inc.* v. *U. S.* (1956), 231 F. 2d 870.

Furthermore, it would appear that, in the instant case, where almost all the facts were stipulated and where the testimony of the only witness was accepted by both parties at full face and in full faith, the appel-

late court should have abandoned the "clearly erroneous" rule. In not so doing the lower court would appear to be in conflict with this Court in the cases of *Comm.* v. *Heininger* (1943), 320 U. S. 467, and *Helvering* v. *Tex-Penn Oil Co.* (1937), 300 U. S. 481. These cases are authority for the position that "If the finding involves an ultimate fact, rather than the evidence on which it is based, the appellate court may substitute its judgment for that of the Tax Court." See also the Third Circuit in *Electric Machine Co.* v. *Comm.* (1957), 242 F. 2d 947.

CONCLUSION.

For the reasons stated, this petition for a writ of certiorari should be granted.

Respectfully submitted,

WILLIAM R. BAGBY,
1107 First National Building,
Lexington, Kentucky,
Counsel for Petitioner.

April, 1965.

APPENDIX A.

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 15821

RITA G. SHEPHARD, Guardian of Susan Shephard,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION to Review the Decision of the Tax Court of the United States.

OPINION—Decided and Filed January 14, 1965.

Before PHILLIPS and EDWARDS, Circuit Judges and MCALLISTER, Senior Circuit Judge.

PER CURIAM. The Tax Court determined an income tax deficiency of $8,687.50 for the year 1958 against petitioner as transferee of the estate of Clarence E. Shephard, deceased.

Mr. Shephard, a resident of Columbus, Ohio, owned practically all of the capital stock of a small family corporation, Croppers Laundry, Inc. He entered into a contract to purchase this stock on January 31, 1944, for $29,000, making an initial cash payment of $8,000, and executing eighty-four promissory notes of $250 each, plus interest in the amount of $46.80, payable monthly. Although the stock was purchased personally by Mr. Shephard and registered in his

name, the corporation became a joint obligor on these notes and executed a chattel mortgage on its physical assets as security therefor. The corporation paid most of the notes as they became due and advanced additional sums of cash to Mr. Shephard over a period of several years. Also, some of the notes were paid personally by Mr. Shephard as they fell due. In this way he acquired almost all of the capital stock of the corporation, partly with his own money and principally with money advanced by the corporation.[1]

The money expended by the corporation for the payment of notes which had been issued for the purchase of the stock, and for cash advances made to Mr. Shephard, were carried on the corporation books as "Accounts receivable, Clarence E. Shephard." Mr. Shephard made only two payments to the corporation on this account, totaling $3,050. The debit balance on this account as of the date of Mr. Shephard's death was $24,241.32.

For a number of years the books and records of the corporation had been kept and maintained in the office of the corporation's accountant, and entries were made by him and his employees as transactions occurred and came to his attention. When the accountant for the corporation made inquiry of the administrator of Mr. Shephard's estate concerning this account, the administrator informed him that it would not be paid. The accountant thereupon charged off this account receivable against the corporation's earned surplus. This action was taken by the accountant on his own initiative, without authorization by the officers and directors of the corporation, but was reflected in financial statements submitted every four weeks by the accountant to the corporation. Mr. Shephard's estate was solvent,

---

[1]Twenty-five shares of stock were paid for by Mr. Shephard's sister-in-law. One qualifying share was held in the name of Scott Reed but actually belonged to Mr. Shephard. At his death Mr. Shephard was the recorded owner of 224 shares.

the principal assets being his shares of stock in the corporation and real estate valued at $25,000. No contention was made in the Tax Court or in this court that the debt was not fully collectible from the estate.

The Tax Court held that the cancellation of Mr. Shephard's indebtedness to the corporation constituted a distribution of property to his estate in 1958, and as such was a taxable dividend for that year, under Sections 301, 316(a) and 317 of the Internal Revenue Code of 1954.[2]

---

[2] "26 U. S. C., Sec. 301. DISTRIBUTIONS OF PROPERTY.

"(a) In General.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

. . . . . .

"(c) Amount Taxable.—In the case of a distribution to which subsection (a) applies—

"(1) Amount Constituting Dividend.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

. . . . . .

"26 U. S. C., Sec. 316. DIVIDEND DEFINED.

"(a) General Rule.—For purposes of this subtitle, the term 'dividend' means any distribution of property made by a corporation to its shareholders—

"(1) out of its earnings and profits accumulated after February 28, 1913, or

"(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

"Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provisions of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection. . . .

(Footnote continued on following page)

Petitioner contends that money paid out by the corporation constituted dividends in the year in which payments were made, and that the taxes due thereon have been barred by limitation.

It is undisputed that the payment of notes and other advances were carried on the books of the corporation as debts due from Mr. Shephard, and that Mr. Shephard recognized this indebtedness by making two payments thereon prior to his death. The petitioner made no showing before the Tax Court that Mr. Shephard declared any of these advances as income for tax purposes for any year duiring his lifetime.

The Tax Court said (omitting citations):

> "Whereas, the entires may have been made without specific instruction from the corporation acting through its officers, directors or stockholders, it is clear that shortly thereafter the corporation and the Estate knew about the action and accepted, ratified and affirmed it. Petitioner has produced no evidence to the contrary.
>
> "The petitioner has not met her burden of proof either to establish that the respondent's determination was wrong, . . . or to support her contention that advances to Shephard from the corporation were dividends in the years they were made. . . . Both parties to the transaction prior to Shephard's death in 1957 treated the transaction as an indebtedness and not as a distribution of earnings. The corporation

---

"26 U. S. C., Sec. 317. OTHER DEFINITIONS.

"(a) Property.—For purposes of this part, the term 'property' means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)."

carried the account on its books as a receivable and for all of its fiscal years from 1945 through 1957 carried the balance due as an asset on its balance sheets.

. . . . . .

"The decedent recognized his debt to the company on at least two occasions by making payments on the account and the payments he made were reflected on the corporate books as credits against the balance then due. Petitioner produced no evidence as to how Shephard treated the advances to him on his own tax returns through the years if he did so at all, and we cannot assume in the absence of such evidence that he reported them as dividends at any prior time. Both parties therefore, so far as this record shows, always treated the transaction as one of corporate loans to the majority stockholder and the petitioner made no showing of other treatment by either party."

This court has held that cash withdrawals from a corporation made by a stockholder constitute taxable dividends in the taxable year during which corporate action was taken canceling or charging off such accounts against surplus. *Hudson* v. *Commissioner of Internal Revenue,* 99 F. 2d 630 (C.A. 6), cert. denied, 306 U. S. 644; *Cohen* v. *Commissioner,* 77 F. 2d 184 (C.A. 6), cert. denied, 296 U. S. 610.

Petitioner contends that a "constructive dividend" requres proof of "economic benefit," relying upon *Whitfield* v. *Commissioner,* 311 F. 2d 640 (C.A. 5). It seems obvious to us that by the cancellation of this indebtedenss there was an economic benefit both to the estate of Mr. Shephard and to petitioner as transferee.

It is our opinion that the findings of the Tax Court are not "clearly erroneous," *Commissioner* v. *Duberstein,* 363 U. S. 278, 291, but to the contrary are clearly correct.

The decison of the Tax Court is affirmed.

JUDGMENT—Filed January 14, 1965.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

No costs awarded. Rule 23(4).

Entered by order of the Court.
(s) Carl W. Ruess, Clerk.

APPENDIX B.

STATUTES INVOLVED.

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTION OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * * * * *

(26 U.S.C. 1958 ed., Sec. 301.)

Statutes

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.
(26 U.S.C. 1958 ed., Sec. 316.)

Treasury Regulations on Income Tax (1954 Code):

§1.301-1 *Rules applicable with respect to distribution of money and other property.*

* * * * * * * *

(m) *Cancellation of indebtedness.* The cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property.

* * * * * * * *

(26 C.F.R., Sec. 1.301-1.)

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 1122

RITA G. SHEPHARD, GUARDIAN OF SUSAN SHEPHARD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In 1944 Clarence E. Shephard (petitioner's husband) purchased 90 percent of the common stock of Croppers Laundry, Inc.[1] He paid part of the purchase price in cash and executed a series of notes for the remainder. Over a period of years the corporation paid many of these notes as they came due and advanced additional sums of cash to Shephard. The amounts paid by the corporation on the notes as well as the cash advances to Shephard were carried on the corporation's books as "Accounts Receivable, Clarence E. Shephard". Before his death in mid-1957, Shep-

[1] Shephard purchased all of the common stock but sold 10 percent to his sister-in-law (R. 30a).

775-788—65

hard made two payments on this account, leaving a balance of $24,241.32 owing to the corporation. In early 1958, approximately 7 months after Shephard's death the corporation's accountant charged off the $24,241 account receivable against the corporation's earned surplus. Shephard's estate had adequate assets to pay his debt if it had not been forgiven (Pet. 21–23).

The Commissioner asserted a deficiency against the petitioner (who concedes that she is liable for any deficiency as transferee of her husband's estate) on the ground that cancellation of Shephard's debt to the corporation constituted a dividend. The Tax Court upheld the Commissioner's determination (Pet. 23) and the Court of Appeals for the Sixth Circuit affirmed (Pet. 24–25).

A distribution of property by a corporation to a shareholder out of earnings and profits is taxable as a dividend. Sections 301 and 316(a) of the Internal Revenue Code of 1954. (There is no question here that the corporation had adequate earnings and profits.) A corporation's cancellation of a debt owed to it by its principal shareholder qualifies as a distribution of property and thus as a dividend. Treas. Regs., §§ 1.301–1(m), § 1.317–1; *Allen* v. *Commissioner*, 117 F. 2d 364 (C.A. 1); *Estate of Wilson* v. *Commissioner*, 255 F. 2d 702 (C.A. 5), affirming *per curiam* 27 T.C. 976; *Cohen* v. *Commissioner*, 77 F. 2d 184 (C.A. 6), certiorari denied, 296 U.S. 610; *Hudson* v. *Commissioner*, 99 F. 2d 630 (C.A. 6), certiorari denied, 306 U.S. 644;

Wiese v. *Commissioner*, 93 F. 2d 921 (C.A. 8), certiorari denied, 304 U.S. 562; *Waggaman* v. *Helvering*, 78 F. 2d 721 (C.A.D.C.), certiorari denied, 296 U.S. 618. In the *Allen* case, *supra*, the court of appeals stated (p. 368):

> * * * It is settled that withdrawals by stockholders giving rise to debts, under the circumstances here disclosed, are taxable to the stockholders as dividends in the year in which the indebtedness is cancelled by the corporation. * * *

Petitioner does not quarrel with these legal principles but argues that they are inapplicable here for two reasons:

1. Petitioner contends that the debt was not cancelled in 1958 but in some other year. In support of this argument, she cites a number of cases where a corporation made payments on behalf of a shareholder or employee and the court held that the amount paid was taxable as a dividend or as compensation at the time of the payment.[2] In each of those cases it was clear that the shareholder or employee would not reimburse the corporation for its expenditures; no account receivable was set up and no claim was made by the corporation against the shareholder or employee. Thus the amount of the payment to or for the benefit of the shareholder was a dividend at the time the

[2] *Yuengling* v. *Commissioner*, 69 F. 2d 971 (C.A. 3); *Commissioner* v. *Bonwit*, 87 F. 2d 764 (C.A. 2); *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4).

payment was made.[3] Petitioner also cites two cases where the courts determined as a question of fact whether the shareholder's debt to his corporation had been cancelled or not.[4] But the cases support the government's position; here the Tax Court, treating the question as one of fact, found that Shephard's debt to the corporation had been cancelled in 1958 (R. 40a). The court of appeals affirmed this finding of fact and it is supported by the evidence (Pet. 24–25).

While Shephard was alive, both he and the corporation treated the corporation's payments on his behalf and its advances to him as loans from the corporation: the corporation maintained an account receivable on its books and Shephard made two payments to the corporation on the account (Pet. 24–25). The Tax Court found that the action of the corporation's accountant in charging off the debt in February 1958 was either authorized or subsequently ratified and affirmed by the corporation and Shephard's estate (R. 40a). The corporation's financial statements (submitted to the corporation monthly) and its 1958 tax return (signed by its vice president and gen-

---

[3] Retitioner cites *Burnet* v. *Wells*, 289 U.S. 670, where the Court upheld the constitutionality of a statute providing that the income of a trust is taxable to the grantor to the extent it is or may be used to pay the premiums on insurance policies on his life. If the case has any tenuous relation to the corporate area involved in the instant case, it is in accord with the cases discussed *supra* in text and cited in footnote 2, since the premium payments were not a loan or advance to the grantor but an outright payment without expectation of or claim for reimbursement.

[4] *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2); *Whitfield* v. *Commissioner*, 311 F. 2d 640 (C.A. 5).

eral manager) showed that the account receivable had been charged off in 1958 (R. 34a). Although the administrator of Shephard's estate had been informed of the $24,241 debt to the corporation, it was not listed on the estate tax return filed for Shephard's estate, thus further evidencing the administrator's recognition that the debt had been forgiven (R. 31a–32a). The Tax Court's findings of fact on this issue are clearly in accord with the evidence.

2. Petitioner also argues that Shephard's estate received no economic benefit from the forgiveness of indebtedness and thus that it should not be taxed as having received a dividend. Petitioner states that the corporation's forgiveness of the debt reduced the value of the corporation's stock held by the estate by $24,241 (the amount of the debt) and at the same time increased the value of the estate's other net assets by the same amount (because of the reduction in the liability against those assets). Petitioner disregards the fact that Shephard's estate owned only 90 percent of the corporation's stock; thus the stock held by the estate declined in value by only 90 percent of $24,241 while the estate's other net assets increased in value by the full $24,241. Thus, contrary to petitioner's assertions the estate did realize an economic benefit from the foregiveness of the debt.

However, even if the estate had owned 100 percent of the corporation's stock, petitioner's argument would nevertheless fail. In such a case the effect of any corporate dividend is to reduce the value of the

corporation by exactly the same amount that it increases the value of the shareholders' other assets. It is the transfer of assets from corporate to individual ownership that produces the tax, since the corporation and its shareholder are separate taxable entities.[5] *Eisner* v. *Macomber*, 252 U.S. 189, 209. Were this not so, no cash dividend paid by a corporation would be taxable to its shareholders.

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
MELVA M. GRANEY,
ROBERT H. SOLOMON,
Attorneys.

JUNE 1965.

---

[5] Although there is dicta in *Whitfield* v. *Commissioner*, 311 F. 2d 640 (C.A. 5), that might be interpreted as inconsistent with this proposition, the holding of the case is clearly in accord with the respondent's position here. See fn. 4, *supra*.

U.S. GOVERNMENT PRINTING OFFICE: 1965